The Ohlin Lectures

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Protectionism

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Postwar Liberalization

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A backward glance at the postwar years of trade liberalization by the industrialized countries, and at the resurgence of protectionism since the 1970s, offers valuable insights into the historical interplay of interests, ideology, and institutional structure that shaped trade policies, and thus prepares the way for the analysis of future developments.

The Bretton Woods conference, held in 1944, had designed an institutional infrastructure that embodied the principles of a liberal international economic order. Adherence to the rules of the International Monetary Fund would provide macroeconomic equilibrium, without which the maintenance of a liberal trading system is economically less compelling and politically more difficult. The General Agreement on Tariffs and Trade provided rules—reflecting multilateralism and nondiscrimination—that would enable the contracting parties to reap gains from trade according to the principles of the theory of comparative advantage.[1] The institutional *troika* also included the World Bank, which was designed to channel resources to the developing nations in order to strengthen

1. The International Trade Organization, not GATT, was the original trade organization devised at Bretton Woods. It never got off the ground, however.

the liberal infrastructure (which would otherwise have been long on the market and short on sentiment).

The United States, which emerged as the dominant world power after World War II, is generally credited with the evolution of this Benthamite infrastructure for the world economy. The conception was not all American: the role of John Maynard Keynes was pivotal.[2] Indeed, the British view of the matter is conveyed with the characteristic arrogance of the metropolitan elite towards the ex-colonial *nouveau riche* in the doggerel:

In Washington Lord Halifax
Once whispered to Lord Keynes:
It's true they *have the money bags*
But we *have all the brains.*

But evidently the United States played the dominant role, if not in the design then in the propagation and sustenance of this infrastructure. As the major power on the world economic and political scene, it provided the ideology and the political and material support for the new international economic regime. A *Pax Americana* had succeeded the *Pax Britannica* of the nineteenth century.

The question as to why the United States threw its weight behind a liberal trading order is an interesting one. It bears directly on the central question of how interests and ideology influence the present and the future course of pro-

2. Keynes had also planned a commodity-stabilization scheme, with an institution to be called COMMOD. His memorandum on the subject has been published in the *Journal of International Economics* (1974). This institution has not materialized, though concerns regarding volatility in commodity prices are mirrored in the efforts of developing countries at the United Nations Conference on Trade and Development (UNCTAD) and elsewhere to promote commodity-stabilization schemes. Neither Keynes nor anyone else at the time seems to have anticipated the need to make corresponding institutional arrangements, as part of the international infrastructure, to oversee labor migrations across borders.

tectionism in the world economy. But before tackling it, let us review the remarkable consequences of the liberal trading order.

Liberalization and Its Consequences

GATT did not eliminate trade restrictions in one fell swoop; it was an umbrella under which a series of tariff-cutting exercises were undertaken. The process of tariff reduction was spread over seven rounds (not counting the ongoing Uruguay Round, launched in September 1986). In the United States, the average tariff declined by nearly 92 percent over the 33 years spanned by the Geneva Round of 1947 and the Tokyo Round (figure 1). By the early 1980s, the tariff level had gone down to 4.9 percent in the United States, 6.0 percent in the European Economic Community, and 5.4 percent in Japan.[3]

Tariff reduction evidently continued beyond the 1973 success of the Organization of Petroleum Exporting Countries and the difficulties that followed in the remainder of the 1970s. However, the growth of nontariff barriers in the 1970s and the 1980s offset the liberalization of trade that tariff reductions implied. Thus, the unprecedented growth of trade and income that accompanied trade liberalization is evident only until the early 1970s.

From 1953 to 1963, world income grew at an annual rate of 4.3 percent and world trade at a rate of 6.1 percent. For the period 1963 to 1973, the performance was even more dramatic: 5.1 percent and 8.9 percent, respectively (figure 2). This remarkable performance was dominated by the industri-

3. These are the estimated average tariff rates after the Tokyo Round (1974–1979) cuts are fully implemented. See *World Development Report* 1987, figure 8.1.

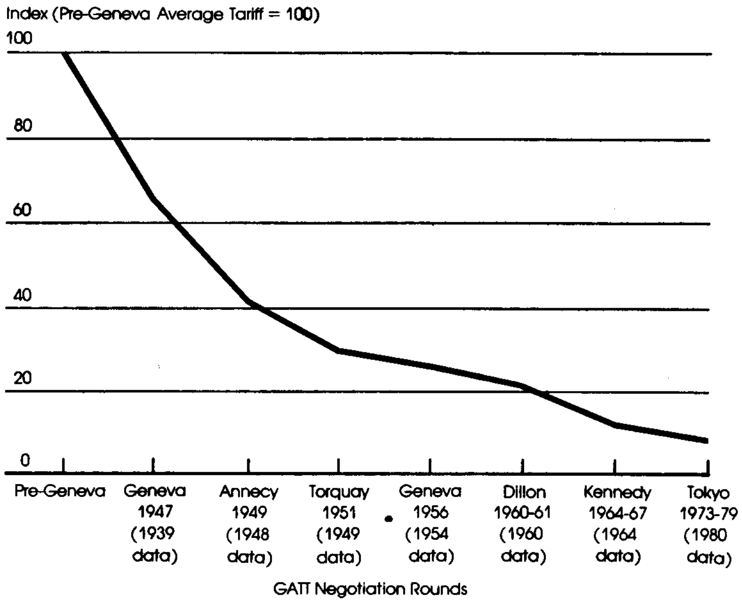

Figure 1 Reductions in average U.S. tariff rates after GATT rounds. Indexes are calculated from percentage reductions in average weighted tariff rates given in Finger 1979 (table 1, page 425) and World Bank 1987 (table 8.1, page 136). Weighted average U.S. tariff rate after Tokyo Round was 4.6 percent (World Bank 1987).

alized countries (figure 3), whose share of world exports was 71.0 percent in 1960.[4]

Did the trade liberalization cause the trade expansion, and did that, in turn, produce the economic prosperity of the 1950s and the 1960s? The fact that trade grew significantly more rapidly than income (figures 2 and 3) is certainly suggestive. The extra edge could well have been due to the steady dismantling of the trade barriers; in fact, it would be astonishing if that were not the case. But the link between trade and income growth is more complex. Did rapid income

4. As late as 1980 it was 66.1%, as calculated from the *International Financial Statistics* (International Monetary Fund 1985, pp. 108–109).

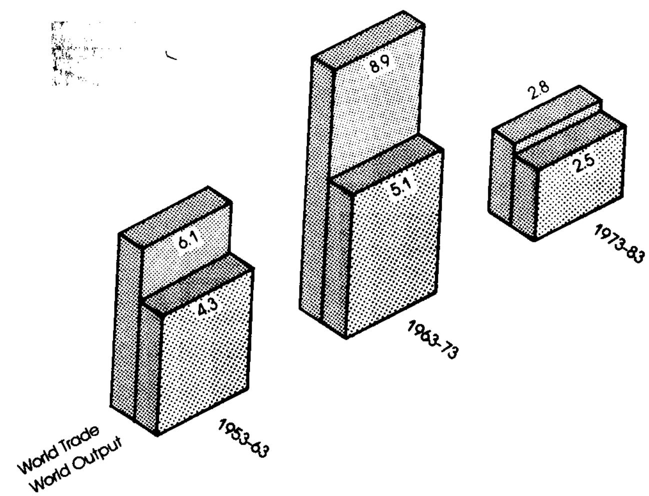

Figure 2 Average annual growth rates (in percent) of world trade and world output for the periods 1953–1963, 1963–1973, and 1973–1983. Source: Hufbauer and Schott 1985, table A-1, page 97.

growth lead to rapid trade expansion, or was it the other way around? I suspect that, as with most economic phenomena, there was a genuine two-way relationship.

From Growth to Trade

An increase in income generally leads to a corresponding expansion of trade, unless the pattern of growth-induced supply and corresponding demands is such as to create an anti-trade bias.[5] In fact, with the trade expansion being focused largely on the industrialized countries, the effect is rather likely to have been characterized by a pro-trade bias. As Staffan Burenstam Linder argued in his seminal 1961 book, intra-industry trade in similar products (for example, small cars

5. This terminology was introduced in the 1950s in the theoretical literature on growth and trade that followed concerns with the "dollar shortage" and the hypothesis that relatively faster U.S. growth and productivity change were responsible for it. See Johnson 1955.

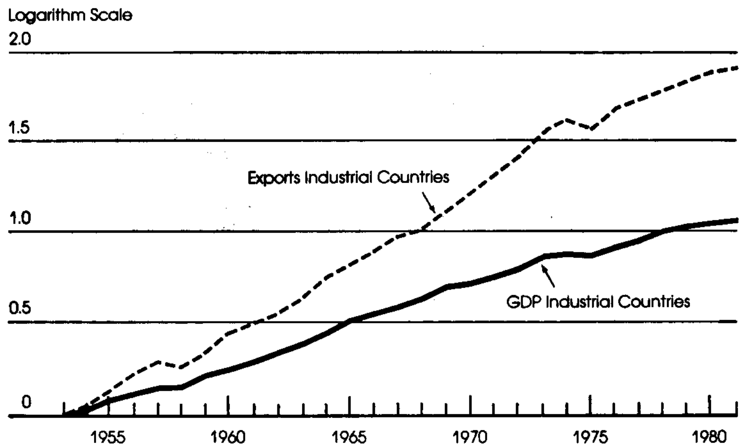

Figure 3 Growth of industrial countries' exports and gross domestic product in the period 1953–1981, based on International Monetary Fund indexes. Sources: International Monetary Fund 1982; International Monetary Fund 1985.

and large cars) is an important characteristic of trade among the industrialized countries. This alone could imply a higher rather than a lower ratio of trade to gross national product as incomes increase and consumption gets increasingly more diversified in terms of variety within broad industry groups while the trading countries continue to specialize in production of similar goods with differentiated characteristics.

At the same time, such intra-industry trade undoubtedly lessened the political costs of trade liberalization and thereby facilitated the process of tariff reduction in the postwar period. If industries have to contract when trade barriers are reduced, resistance to liberalization can be expected; however, if the outcome is more specialization within industries, so that they give up on certain products and increase the manufacture of others, the resistance to liberalization will surely be less.

The evidence confirms that the effect of postwar liberalization and income growth in the industrialized countries was indeed to increase intra-industry specialization rather than inter-industry specialization. In an important study of the European Economic Community, Bela Balassa (1975) analyzed the expansion of intra-EEC trade during the periods 1958–1963 and 1958–1970 and documented the increasing similarity in the pattern of manufactured-goods exports among the EEC countries.[6]

But if intra-industry trade reduced the political costs of tariff cuts, thus easing their progress and contributing to growing shares of trade in national income, so did growing incomes. It is obvious but necessary to recall that, all else being equal, a growing economy reduces the need to contract industries in response to trade liberalization. A mere slowdown in the rate of growth in an industry losing to foreign competition, rather than an absolute decline with its attendant losses and layoffs, can be a pleasing consequence of a growing economy. If tariff cuts lead to more trade, and more trade produces more income, and more income facilitates more tariff cuts, the result is a "virtuous circle" that can produce the level of prosperity we saw in the glorious 1950s and 1960s.

From Trade to Growth

It is plausible that liberalization-induced trade expansion, through its efficiency effects (called in jargon the "gains from trade"), fed the postwar growth of incomes. Now, it is indeed possible to construct theoretical cases in which, paradoxically, the effect of trade liberalization on growth is perverse. Imagine that liberalization shifts the distribution of income in favor of groups that save less. Then, if the national savings rate is determined not by fiscal policy but by the

6. See Balassa 1975, pp. 108–110, for details.

market-determined distribution of income, the liberalization will improve current income but may reduce its rate of growth (which reflects not just current productivity but also the rate of savings and investment).[7] But surely there is no reason to consider such paradoxes relevant to the broad postwar experience.

Nor need one be bothered by the occasional argument that trade liberalization brings a one-time-only gain in income rather than a sustained improvement in growth.[8] A substantial trade liberalization could spread a one-time-only effect over two decades. Besides, there have been repeated tariff cuts through the many rounds (recall figure 1), so a favorable effect on growth rates could have been repeated, and thus sustained, through an extended period without any difficulty.

But what is one to make of the contention that growth rates can reflect a host of factors other than trade liberalization (including, in the European case, a "catching-up" or "recovery" phenomenon that might accelerate growth back to pre–World War II rates)? Indeed, few phenomena in economics can be explained by reference to single causes. But this does not rule out the possibility, and indeed the overwhelming probability, that diminishing trade barriers were a major contributory force in the postwar expansion of incomes. It would be a *non sequitur* to argue that, because other factors also influenced growth, trade liberalization could not have done so. In fact, several empirical analyses of time-series data for specific countries—analyses in which other contributory factors have been controlled for in principle—have underscored the link between trade liberalization and improved export performance (and, hence, enhanced economic performance).[9]

7. For a discussion of this possibility, see Bhagwati 1968. For a careful, analytical demonstration, see Pattanaik 1974. See Corden 1971 for a more comprehensive analysis of the effect of trade on the rate of growth, and Findlay 1984 for an elegant and complete analytical model addressed to this issue.

8. This argument is not valid in the Harrod-Domar model, where an improved productivity of resources will permanently improve the growth rate, given the savings rate. In the Cobb-Douglas model, however, the growth rate cannot be permanently improved by a one-time-only improvement in productivity. See Solow 1956.

Exceptions to Liberalization

There have been some important exceptions to the trend toward liberalization. Some of them were present from the outset; others arose as the postwar period unfolded.

Agriculture

Exempted from most of GATT's discipline,[10] agriculture suffered yet further from the 1955 waiver granted to the United States, and from its spread thereafter (a historical fact that seems somewhat ironic today, in view of U.S. conversion on this issue). There was hardly any support for the inclusion of

9. This evidence, for many semi-industrialized developing countries, was accumulated in massive research projects undertaken in the 1960s and 1970s at the Organization for Economic Cooperation and Development, the World Bank, the National Bureau of Economic Research, and the Kiel Institute of Development Economics. These and other findings, and the explanations of the link noted above, are reviewed in Bhagwati 1985c, 1986c and in Balassa 1986. I admit, however, to sharing the view that cross-section evidence on the question is less persuasive, since one cannot meaningfully control for several factors that may differentially affect the growth of the countries in the sample. Thus, it does not really make sense, no matter how good your R^2, to infer a link between trade liberalization and growth rates by putting on one regression line countries with totally different savings rates, foreign investment, shares of public in total investment, and so forth.

10. Loopholes for agriculture were written into Articles XI and XVI from the start.

agriculture on the liberalization agenda, because the United States and the major developed countries of Europe were generally captive to strong protectionist lobbies that had constructed elaborate mechanisms of agricultural income support. At the same time, the major developing countries were protecting their manufactures instead and therefore were not interested in lobbying for agricultural trade liberalization.[11] If I may paint with a very broad brush, the postwar period found the developed countries stoutly protecting their agriculture while steadily dismantling protection for their manufactures, while the developing countries protected their manufactures through a combination of trade and exchange restrictions and therefore (inadvertently) created disincentives for their agriculture. The political preference for "agriculturalization" in the developed countries was matched by that for "industrialization" in the developing countries. (Eventually the United States—perceiving its comparative advantage in agricultural trade—lent its immense weight to the inclusion of agriculture on the agenda of the Uruguay Round.)

But the major exceptions to trade liberalization, which manifested themselves as the process unfolded and which (in hindsight) turn out to have been indicative of the protectionist problems that would surface more clearly in the 1970s, lay elsewhere. Today's "systemic" threats to freer trade are the persistent use of nontariff barriers to meet sectoral difficulties in the developed countries and the pervasive and sustained use of trade and exchange restrictions to manage the balance of payments and to protect domestic industries in the developing countries. Both problems became manifest early on.

11. I doubt that even a strong desire for agricultural trade liberalization by the major developing countries would have made much difference in the early postwar years, given their relatively small role in overall world trade and their low political profile and clout.

Textiles

The proliferation of nontariff barriers was presaged by efforts to organize trade in textiles. In 1961 the United States, under pressure from the domestic industry, managed to get the Short-Term Cotton Textile Arrangement negotiated. That arrangement led, in the following year, to the Long-Term Arrangement Regarding International Trade in Textiles, which consisted, in essence, of a series of bilateral agreements under which import quotas were fixed by source, thus sanctifying the use of voluntary export restrictions (bilateral quotas mutually agreed upon and assigned to specific exporting countries). Since such arrangements inherently discriminate among supply sources, getting them negotiated under GATT—which strongly affirms the nondiscriminatory most-favored-nation principle—was like getting the pope to preside over a pagan rite.

GATT also compromises on the most-favored-nation principle in dealing with the question of integration. Article XXIV legitimates the formation of customs unions and free-trade areas and permits member countries to join these arrangements to cut tariffs for one another but not for other member countries, thus denying the latter the benefit of their most-favored-nation rights. In practice, Article XXIV has been invoked with even more latitude than was originally conceived, reflecting accommodation to the political objectives of powerful GATT members. The United States, broadly sympathizing with the political objectives and implications of European integration, threw its weight behind a relaxed interpretation of Article XXIV when the European Economic Community was formed.[12] But in view of its conviction that the most-favored-nation (MFN) principle was valuable, the United States abstained from resorting to Arti-

12. See Jackson 1969, p. 589.

cle XXIV, preferring multilateral MFN-based trade liberalization through the 1970s. However, in the 1980s, the United States, in a more wide-ranging reversal of its pro-MFN attitudes and policies, turned to Article XXIV to initiate a yet looser free-trade area with Israel and to work toward a similar preferential arrangement with Canada.

The Developing Countries

But whereas these acts of omission (agriculture) and commission (the Long-Term Arrangement in textiles and other exceptions to MFN-based multilateralism) were due to political pressures from the powerful, the ability of the developing countries to virtually escape symmetric GATT obligations of access to their own markets by others was due to their weakness.

The economic theories and ideological predilections that led the developing countries toward extensive protection and the associated import-substitution programs were undoubtedly important, and I will describe them presently. But their ability to get GATT to accommodate to the resulting situation by adopting the doctrine of *special and differential treatment,* under which the member developing countries would enjoy the benefits of increasing market access abroad while being exempted from having to offer greater access to their own markets,[13] was surely due to their unimportance in trade rather than their political strength in negotiations. The demands of these countries could, in consequence, be accommodated, fraying the liberal trading regime only at the margin while securing a large and growing membership of the institution that embodied the principles of the liberal order. At the same time, the relative economic insignificance of these countries in world trade implied that the "cost" to others of their asymmetric escape from the process of liberalization was small enough to warrant neglect and invite indulgence.

The consequence of this asymmetry was that the developing countries, a growing political and economic reality through the postwar period, generally exhibited high trends of protection throughout this period.[14] These levels of protection appear to have been high relative to those calculated for several currently developed countries in the early twentieth century, as table 1 shows.[15] They were certainly higher than the protection levels of the developed countries—a situation that would continue even with the offsetting growth of nontariff barriers in the developed countries during the 1970s and recently. Indeed, by recent UN Conference on Trade and Development estimates, in 1986 the developing countries seemed (in percentage of items affected by such nontariff barriers) to outperform the developed countries quite handsomely in virtually all classes of imports, including agricultural materials, ores and metals, and manufactures.[16]

Warts and all, however, the postwar trade liberalization was a major accomplishment. What brought it about?

13. Special and Differential treatment also extends to the different question of preferential treatment of the developing countries in their access to the markets of the developed countries. Part IV of GATT was introduced largely to legitimate schemes giving such preferences.

14. Among the more important documentations of the high protection levels in major developing countries during the 1950s and 1960s is Balassa 1971.

15. This conclusion needs some qualification insofar as the "natural" protection found in the earlier periods would be greater because of higher transport costs. Note, however, that the table considers only tariff rates, whereas import quotas have been substantially more important in the developing countries in the postwar period.

16. The overall estimate of this incidence was more than 3 times as high for the developing countries as for the developed countries, as figure 4 shows. This asymmetry of trade barriers among the two blocs of countries is illuminatingly documented in Laird and Finger's (1986) study, which is based on documentation produced under the auspices of the International Bank for Reconstruction and Development (i.e. the World Bank) and UNCTAD.

Table 1

Estimates of nominal tariff levels for manufactures (percent). Source: Little et al. 1970, table 5.1.

	1902	1913	1925	
Developed and European Countries				
Russia	131			
Spain	76	41	41	
United States	73	44	37	11.5 (1962)
Portugal	71			
France	34	20	21	
Italy	27	18	22	
Germany	25	13	20	
Sweden	23	20	16	6.6 (1962)
Denmark	18	14	10	
Canada	17	26	23	
Belgium	13	9	15	
Norway	12			
New Zealand	9			
Japan	9			16.1 (1962)
Switzerland	7	9	14	
Australia	6	16	27	
Netherlands	3	4	6	
European Economic Community				11.0 (1962)
Developing Countries				
Argentina	28	28	29	141 (1958)
Brazil				99 (1966)
Mexico				22 (1960)
British India	3	4	16	
Pakistan				93 (1963/4)
Philippines				46 (1961)
Taiwan				30 (1966)

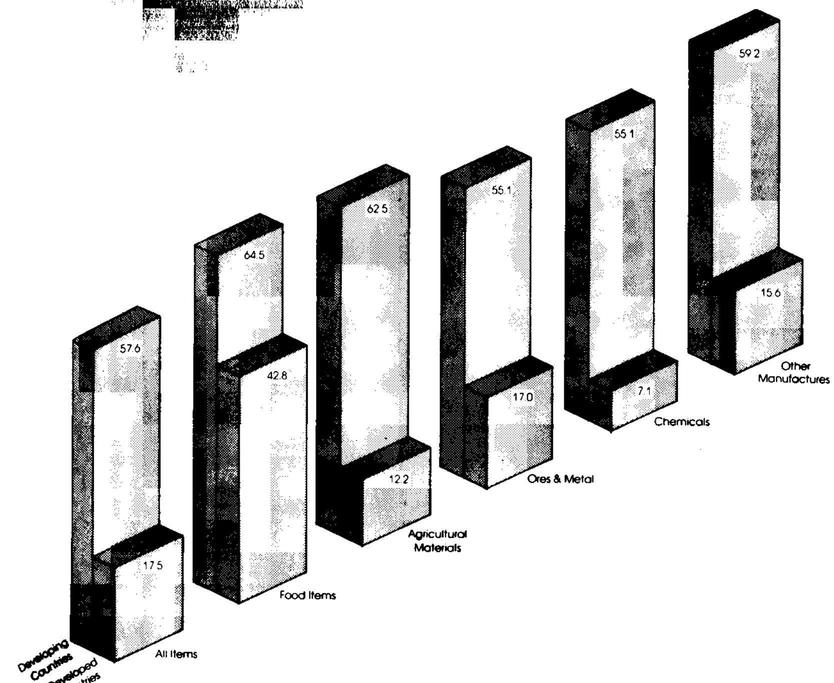

Figure 4 Percentage of items affected by nontariff measures (including quotas, prohibitions, restrictive exchange allocations, other financial requirements, price-control measures, automatic licensing, and technical requirements) applied by fifty developing countries and fifteen major developed countries in 1986. (If two measures affect an item, only the items affected are counted, irrespective of the number of measures they face. Items are covered at the four-digit CCCN level. The percentages measure the items affected as a proportion of all possible items.) Source: UNCTAD 1987.